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THE RURAL CREDITS ACT AND ITS EFFECT ON THE INVESTMENT MARKET

BY ROGER W. BABSON.

Although nearly everyone realizes that the farm products of the United States are one of the chief sources of our wealth, and many people even believe that our whole prosperity depends on good crops, still there are comparatively few investors who are willing to put their money into the farm loans which are being issued today. Moreover, those who do invest in them are able to exact anywhere from 5 per cent to 12 per cent and in some cases even much higher interest rates on such funds. Why is this so? The answer is that the farmer has never put up his securities in the right kind of a package, and he has failed to advertise. Consequently, his loans have had only a narrow market and have not commanded the terms to which the farmers' credit has really entitled him. These are the things the new Rural Credits Act proposes to do.

There was a time about thirty-five years ago when farm loans were the rage. It was during the period when the Middle West was booming and speculators had pushed land prices way beyond their real value. At that time the loan and trust companies handling the accounting of farm purchases had loaned up to two-thirds of those inflated prices. Then came the wild scramble for the new lands farther west. Eastern holdings fell to half their mortgage face value, and throughout the late '80's and early '90's they were practically unsalable. Then in the far west the same wild cat financing soon took place. Many investors who had lost in the local eastern trusts and loans tried to recoup themselves in these new western ventures, and were caught again in the collapse caused by the panic of 1893.

PRESENT DISTRIBUTION OF FARM LOANS

Although the memories of those days have never been entirely wiped out, the status of our rural credits has since then been almost reversed, and farm mortgages, as a whole, during the late years have really come to rank among the safest investments. This fact is

shown by the great interest taken in these loans by banks, insurance companies, and similar institutions which have practically a monopoly of this business at the present time. In this connection some figures compiled by Mr. C. W. Thompson of the United States Department of Agriculture are exceedingly interesting. Mr. Thompson estimates the total farm mortgage debt of the United States as about \$3,600,000,000. Of this amount the banks appear to furnish from their own funds approximately \$740,000,000 or more than one-fifth. This proportion of course varies in the different sections of the country, and in certain states is very much larger than one-fifth. For instance, in California the farm mortgages held by banks represent 45 per cent of the estimated total farm mortgage debt; in Louisiana 45 per cent; in Indiana and Michigan nearly 40 per cent and in Mississippi and South Carolina more than 36 per cent.

Life insurance companies are of almost equal importance in this field. Of the total, they supply approximately \$700,000,000 which is nearly one-fifth of the total amount of farm mortgage capital of the United States. The insurance companies have confined their operations largely to the four states of Iowa, Missouri, Kansas and Nebraska, practically one-half of the total amount of insurance money being invested in these four states. Iowa alone holds over \$150,000,000 of such investments by insurance companies. In Nebraska the insurance companies have over 40 per cent of the business; in South Dakota 33 per cent; in Kansas 35 per cent; in Indiana 37 per cent; in Oklahoma 40 per cent and in Georgia over 50 per cent. These life insurance companies either have their own farm mortgage loans department through which they receive and pass on all applications for loans, or they purchase farm mortgages outright in the commercial market.

The latter practice is generally limited to the smaller insurance companies, their volume of business in this field not being sufficient to warrant the maintenance of separate machinery for the selection of farm mortgage securities. Nearly all the larger companies, however, have well organized departments through which they carry on a regular farm mortgage loan business. Ordinarily these companies receive applications from their local agencies or banks. The application blanks and legal papers used by these companies have been carefully standardized and adapted to

the conditions of the various states of which loans are made. Really the system has been worked out in excellent shape and for the most part the insurance companies which have such an organization are at the present time giving the farmers very good service. While some of the companies show a tendency to charge high rates, insurance companies as a rule represent a conservative class of investors in the farm mortgage business.

Figures are not at hand to show the amount of capital invested in farm mortgage loans by mortgage companies, but these companies are all prominent in nearly all parts of the country, and there are a number of foreign mortgage companies who are heavily interested in the West, South, Central, Rocky Mountain and Pacific States. It is also impossible to tell just how much capital is supplied by private investors. In certain states, however, such as New York, Pennsylvania, Michigan and Wisconsin, the amounts of such capital are relatively large. I have quoted these statistics simply to give some idea of the situation as it now stands. Generally speaking the farmers have been receiving good service in their financing; *but many of them have had to pay very dearly for it.*

HIGH RATES OF INTEREST PAID BY FARMERS

In short, the matter of interest rates charged on farm loans is really the cause of the Rural Credits Bill. Of course conditions vary with the different sections of the country. In New England and the Middle Atlantic states and a few of the Middle Western states a considerable part of the farm loans carry as low as 5 or $5\frac{1}{2}$ per cent interest; but in certain of the western and southern states, 10 and 12 per cent, and even much higher rates have been exacted by lenders. As we have stated above, the fault has not been entirely with the mortgage companies or other institutions who bought farm loans, but rather with the farmers, who failed to mobilize their credit so that the rank and file of investors could interest themselves in their securities.

Certainly from an investment standpoint, these farm loans have been an excellent proposition for any investor or institution that had the proper facilities for selecting and purchasing them. On the other hand, the average investor could not take the risk of lending his money to a farmer he had never seen, nor did he feel any safer in taking as security a mortgage on property he knew

absolutely nothing about. Moreover, as farm loans are not listed on any of the exchanges, it has been difficult for him to purchase such loans if he cared to, unless he happened to live in a farming community. These are the difficulties which the Rural Credits Act aims to correct.

THE REVOLUTIONARY NATURE OF THE NEW LAW

Really this is one of the most revolutionary pieces of legislation ever enacted in this country. In a nut shell, the new plan is this: First the country will be divided into twelve districts, each of which will have a farm land bank. These banks will be operated much the same as any other bank with a president, and all the usual banking machinery. Farmers who wish to obtain loans will form local associations through which they may make application to the farm loan bank of their district. This bank will take the mortgages on their farms as security for the desired loans. It will then turn over these mortgages as collateral to the Federal Farm Loan Board at Washington, which has supervision over the entire system, and from it will receive authority to issue bonds to cover the loans which it has made. These bonds are the crux of the whole plan. They will be in denominations of \$25, \$50, \$100 and \$1,000 and will probably be listed on the New York Stock Exchange. Although the rate of interest will not exceed 5 per cent per annum, and will probably be considerably less, still they will be exempt from all taxation and their security should be above question. These features should guarantee for them a good demand.

THE MAIN FEATURES OF THE PLAN

The above is simply the bare skeleton of the plan, but in order to appreciate the status of these new securities and their probable effect on other investments, we must first know more about the organization and detail of the system. There are really five parts of this big money loaning machine. These parts may be briefly described as follows:

(1) *National Farm Loan Associations.* These are local associations which may be formed by any ten or more farmers in a good locality who are already, or about to become, land owners and who wish to borrow an aggregate of \$20,000. They are really little combinations of borrowers who band themselves together for the

purpose of securing money. Each association will have a board of not less than five directors, and the directors will elect a president, vice-president, secretary-treasurer and a loan committee of three members.

The organization of the farm loan associations is such that the farmers will have a direct interest in their successful operation. Each association has capital stock valued at \$5 a share, of which each member must buy an amount equal to 5 per cent of his loan. Moreover, in case the association should default, this stock carries a double liability, the owner being obliged to furnish an amount equal to the value of his stock, as in the case of the national banks stocks. It is evident, therefore, that each member of the association will see to it that no bad loans are made. Their loan committee will appraise each property and each loan must be approved by their board of directors, all of whom are members and own stock in the association. Each member will therefore be well protected against bad loans. The secretary-treasurer, who handles all funds, will be under surety bond. Moreover, no loans will be made to exceed 50 per cent of the value of the land, or 20 per cent of the value of the buildings, which is an exceptionally wide margin. It is evident that these farm loan associations are really the cornerstone of the whole system.

(2) *The Federal Land Banks.* As soon as practicable, the country will be divided into twelve districts known as federal land bank districts. Each district will be given a number. They will be arranged with proper regard to the farm loan needs of the country, but no district will be a fractional part of any state. In some convenient city of each of these twelve districts there will be located a Federal Land Bank. Moreover, this bank may have branches in other parts of this district. Each federal land bank will have a capitalization of at least \$750,000, in shares of \$5 each, which may be subscribed for and held by individual firms or corporations, or by the government of the United States. No stocks will have any voting rights, except shares owned by the United States and by the national farm loan associations (above described), but all stock except that held by the United States will share in any dividend distribution.

While this stock will be offered to the public, it is not expected to receive a very enthusiastic reception. Dividends, at least for

a time, will probably be small and the stock carries no voting power when held by the individual investor. The intention is to have this stock eventually held by the farm loan associations. When a farm loan association makes application to a land bank for a loan, it must accompany the same with a subscription for stock of the land bank equal to 5 per cent of the value of the loan desired. This of course really means that the individual farmers will own the stock, but all of the dealings of the federal land bank are with the association as a body. No transactions whatever take place between the land bank and the farmers individually. In case of default, it is the association and not the individual which is held responsible by the land bank. This is an important feature, greatly increasing the security of the system.

In their functions these land banks will occupy a position similar to that of the Federal Reserve banks. All applications for loans will be made by the farm loan associations to their respective land banks. The bank will then verify the report of the loan committee of the association (mentioned above) by having an appraisal made by its own appraisers. If the security appears to be satisfactory, it then forwards its check for the amount of the loan to the association. In order to obtain cash to make these loans, the federal land banks have the power to issue bonds against the first mortgages which they have taken as surety for the loans to the associations. These bond issues, however, must first be approved by the Farm Loan Board.

(3) *Federal Farm Loan Board.* At the head of the federal farm loan banks will be a Federal Farm Loan Board. This board will have its headquarters at Washington. The Secretary of the treasury and four others appointed by the President of the United States make up this board. The men who have been chosen for these positions are Charles E. Lobdell, Republican, of Great Bend, Kansas; George W. Norris, Democrat, Philadelphia; Capt. W. S. A. Smith, Republican, of Sioux City, Iowa; and Herbert Quick, Democrat of Berkeley Springs, West Virginia. Mr. Lobdell has been a farmer, a lawyer and a banker. Mr. Norris is a director of the Philadelphia Reserve bank. Captain Smith is a farmer. He has been connected with the Department of Agriculture and is an expert in that line. Mr. Quick, formerly editor of *Farm and Fireside*, has devoted himself to the study of rural credits and other

problems connected with farming. The Farm Loan Board in this system corresponds to the Federal Reserve Board in the new banking system. Besides passing on all applications for farm loan bonds, the board has charge of all mortgages, notes, etc., held as surety for outstanding bond issues, and has general supervision over the whole system.

(4) *Joint Stock Land Banks.* The above three wheels make up the machinery. In addition, however, two substitute wheels have been provided, for use in emergencies. The first of these is the joint stock land bank. In order to be fair to certain land companies and banks which have already been established to loan money to farmers, a provision to take care of such banks has been made in the law. By this provision, farmers who do not want to form an association and become a part of the big machine, may go to a private institution (to be known as a joint stock land bank) and there borrow their money. These joint stock land banks will be somewhat the same as national banks, each independent and privately operated.

To borrow money from a joint stock land bank, it will not be necessary to be a member of a farm loan association. Moreover, such a joint stock land bank can issue bonds more freely than a federal land bank and is not so restricted in many ways. The bonds which these joint stock banks will issue will be taxable, but they will not be so fully secured as the farm loan bonds above mentioned. Therefore, while they will pay a higher rate of interest, they will probably not be so attractive as the farm loan bonds above mentioned. Of course, if something unforeseen happens so that the big federal machine does not work smoothly, there will be an opportunity for these private joint stock land banks, but otherwise their growth will be slow.

(5) *Federal Land Bank Agents.* If after the system has been in effect one year it is found that a national farm loan association has not been formed where it is needed, the Farm Loan Board may then appoint some bank, trust company or mortgage company in that locality to act in the capacity of such an association. To my mind this is a very important feature of the law and should insure against its failure. The only weakness here is that the local bank must guarantee the loan, although it receives only one half of one per cent per annum on the unpaid balance for so doing.

ATTRACTIVENESS OF THE FARM LOAN BONDS

Analyzing the new system as we have above, it is evident that everything has been done to make the farm loan bonds absolutely safe and as attractive as a low yielding bond can be. There are four features to these bonds which are especially important: (1) The bonds are secured to at least their face value by first mortgages on farm property; (2) They are secured to the extent of 10 per cent by the land bank stocks owned by the associations in the district in which a default may occur (these stocks are held by the land banks all the time); (3) They are the obligation of all of the other land banks, which are liable for all farm loan bonds issued, whether by them or by some other land bank; (4) Provision is made for the repayment of farm loans on an amortization plan, so that the security behind the farm loan bonds is gradually strengthened. Viewed from all sides, it is evident that these bonds are better secured than even government bonds. Another point which will add greatly to the attractiveness of these bonds is that they are exempt from all taxation. This means a great deal nowadays, as is evident from the tremendous amount of trading in municipal bonds and other non-taxables.

Regarding the effect which these new bonds will have on the bond market, there is a great diversity of opinion. Some claim that there will not be enough farm loan bonds offered to have any definite influence. They believe that most farmers will continue to borrow from the same sources that they have in the past, rather than bother with the new system. Personally I should not be surprised if this were the case at first, but as soon as the farmers realize the great advantages which the new credit system offers them, there should no longer be any lack of applications for loans. I feel especially sure of this in view of the monetary situation in this country. Just now, credit,—that is, for short terms,—is the most plentiful thing we have, but as soon as the war stops we are likely to see an entirely different turn in money rates. Then there will be plenty of use for all of the credit machinery we can bring into play. Moreover, this year's poor crops should also operate toward the same end, especially in sections which have been most severely affected.

Statistics show that at the present time the farmers in at least 22 states are paying an average of 8 per cent or more for money, while in fully 6 states they are paying 10 per cent and 12 per cent,

or even more. Out of the total of about \$3,600,000,000 of farm loans there are about \$900,000,000 drawing 8 per cent or more in interest. Under the rural credits system, the highest rate of interest which can be charged on these loans is 6 per cent, and it is very unlikely that more than 5 per cent interest will be asked. This means that on perhaps a fourth of farm loans, which are now outstanding the farmers can make a saving of from 40 per cent to 100 per cent, or even more in interest charges by joining the new system. Frankly, I do not believe that it will take these farmers long to wake up to the new plan.

THEIR EFFECT ON THE BOND MARKET

What does this mean to the bond market? First, I believe it means that all of our low-yielding, high-grade bonds will find a sharp competition in the new farm loan bonds. Institutions, trustees and individual investors who have been accustomed to buy low-yielding railroad bonds because of their safety, will find in the new farm loan bonds an equal degree of safety coupled with exemption from all federal, state, municipal and local taxes. The result must be a considerable scaling down in prices of the low yielding railroad issues. In fact, these new farm loan bonds will be rivals to United States government, state government and municipal bonds, and their appearance may have a depressing influence on these issues also. At least, the trend should gradually be in that direction.

Another result of the new system will be, *ultimately*, to make good farm mortgages practically extinct, and the holders of the mortgages will gradually turn to other investments yielding from 5 per cent to 6 per cent. For the most part I do not believe that the interests who are now holding farm mortgages will buy the new farm loan bonds, as they are obliged to seek a higher interest return. This demand should tend to stimulate the prices of good high-yielding securities. Of course I do not believe that these changes will come about immediately. The new system will probably not be put into operation until next spring, and as above suggested, it will doubtless be some time after that before it becomes very popular. On the other hand, I do believe that the principle of the new plan is sound, and that eventually it will displace our present system, or systems, of handling farm credits. Wise are the investors who prepare for the changes which will take place.